

University of Nebraska - Lincoln

DigitalCommons@University of Nebraska - Lincoln

Publications of Center for Public Affairs
Research (UNO)

Public Policy Center, University of Nebraska

1987

Community Banking Issues in Nebraska

Alfonso J. Garza

University of Nebraska at Omaha

William R. Hosek

University of Nebraska at Omaha

Follow this and additional works at: <https://digitalcommons.unl.edu/cpar>



Part of the [Public Affairs Commons](#)

Garza, Alfonso J. and Hosek, William R., "Community Banking Issues in Nebraska" (1987). *Publications of Center for Public Affairs Research (UNO)*. 12.

<https://digitalcommons.unl.edu/cpar/12>

This Article is brought to you for free and open access by the Public Policy Center, University of Nebraska at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in Publications of Center for Public Affairs Research (UNO) by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.

Community Banking Issues in Nebraska

3

Alfonso J. Garza
William R. Hosek

During the 1980s, community banks in Nebraska have been challenged by a weak agricultural economy and by deregulation of the financial services industry. Bank profits have fallen and many banks have failed. Of the two problems, deregulation may have more far reaching consequences as it increases the competition faced by community banks. Community banks will have to take advantage of new technology, new marketing strategies, and new sources of income to remain viable. Public policy should aim at removing regulatory and tax barriers that constrain community banks.

A well-developed and healthy financial system is necessary for the development of any economy. This is as true for state and regional economies as it is for national economies. Although the types of institutions that make up the financial system will vary among nations, the dominant institution in the United States is the commercial bank. This is also true for Nebraska. This chapter concentrates on Nebraska's commercial banks.

Community Banks

Community banks are a critical ingredient in the local economy. Yet, commercial banks in general, and community banks in particular, face new challenges in a deregulated financial system. Deregulation, together with a weak agricultural sector, has placed community banking in Nebraska under considerable stress. The stresses of deregulation and agricultural weakness have affected banks simultaneously during the mid-1980s. This makes it difficult to distinguish between the contribution

of each to poor bank performance. Thus, a judgment about the relative importance of deregulation and the agricultural crisis cannot be made with certainty.¹ A detailed, technical model could be constructed to quantify the relative importance of various problems, but is beyond the scope of this study.

The observed effects of the agricultural crisis and deregulation occurred at various times too. The agricultural crisis produced its effects on banks quickly, and the problems may disappear as quickly as the crisis disappears. On the other hand, deregulation of the financial services industry is part of a long run process in the U. S. economy. Its effects will be felt for many years to come. Strategic planning by community banks requires a carefully considered response to long-term trends. Consequently, this chapter focuses on deregulation, while recognizing the impact of the agricultural crisis on recent bank performance.

In this chapter, the extent to which deregulation and the weak agricultural sector have stressed community banks is examined by comparing the performance of community banks with larger commercial banks. Then, recent changes in deregulation and their effects on community banks are reviewed. Next, the ways in which community banks might incorporate responses to deregulation in their long-range planning are discussed. Finally, some overall policies that might ease the transition for community banks from a regulated to a deregulated financial system are presented.

Location of Community Banks

Nationally, the total of all commercial bank assets is over two and one-half times as great as the total assets of the next largest type of depository institution, the

savings and loan association. The comparison is similar for Nebraska, with commercial bank assets about double savings and loan association assets. Although, like the nation, Nebraska has both large and small commercial banks, this discussion focuses on small (community) banks. For our purposes, a community bank is a commercial bank with less than \$100 million in assets, and a large bank is one with \$100 million or more in assets.

At the end of 1986, there were 418 community banks scattered throughout Nebraska.² Some of these community banks exist side by side with large banks. For example, in the Omaha area, in 1986, 17 community banks coexisted with 7 large banks. Omaha and Lincoln were the only cities in Nebraska with more than one large bank (Lincoln has four). In eight other cities, community banks coexisted with one large bank. More commonly, community banks are the major financial institutions in smaller cities and towns in the more rural parts of the state.

Relatively, Nebraska has more community banks than the United States as a whole. In Nebraska, 96 percent of all commercial banks are community banks, compared with 81 percent for the nation. Within their class, community banks in Nebraska vary widely in size, ranging from total assets of less than \$1.5 million to just under \$100 million. Thus, many community banks are as different from each other as they are from large banks. Yet, they all provide important services to their respective communities.

Role of Community Banks

As financial institutions, or intermediaries, community banks perform many functions that assist in economic development and growth. First, they provide a

channel through which the funds of savers can be made available to investors. For example, ordinary savings accounts of banks provide a safe, insured haven for individuals' money. In turn, these funds may be lent by the bank to a farmer who wants to install an irrigation system. The irrigation system improves agricultural productivity and the entire economy of the community benefits.

Second, the loans of community banks may be used to assist in the operations of businesses as well as to provide new investment. A typical example in rural Nebraska would be the financing of seed grain for the farmers. Without short-term loans, only farmers who had sufficient cash to buy seed grain would be able to plant. The result would be a lower level of agricultural output for the community.

Of course, community banks make equipment loans and inventory loans for nonfarm business as well. Agricultural lending, however, has dominated--at least until now.

A third function of community banks involves the means by which payment is made when goods are bought and sold. Cash and checks are the two most widely used means of payment. For years, only commercial banks provided checking accounts. As a result of deregulation, other financial institutions now provide checkable deposits. However, commercial banks still provide over 50 percent of checkable deposits nationwide. In many Nebraska communities, the local community bank may be the only nearby provider of checkable accounts. Moreover, the community bank is the primary institution through which coin and currency can be obtained. Without currency, local business would be inhibited, as people and businesses would lack the means to carry out many transactions.

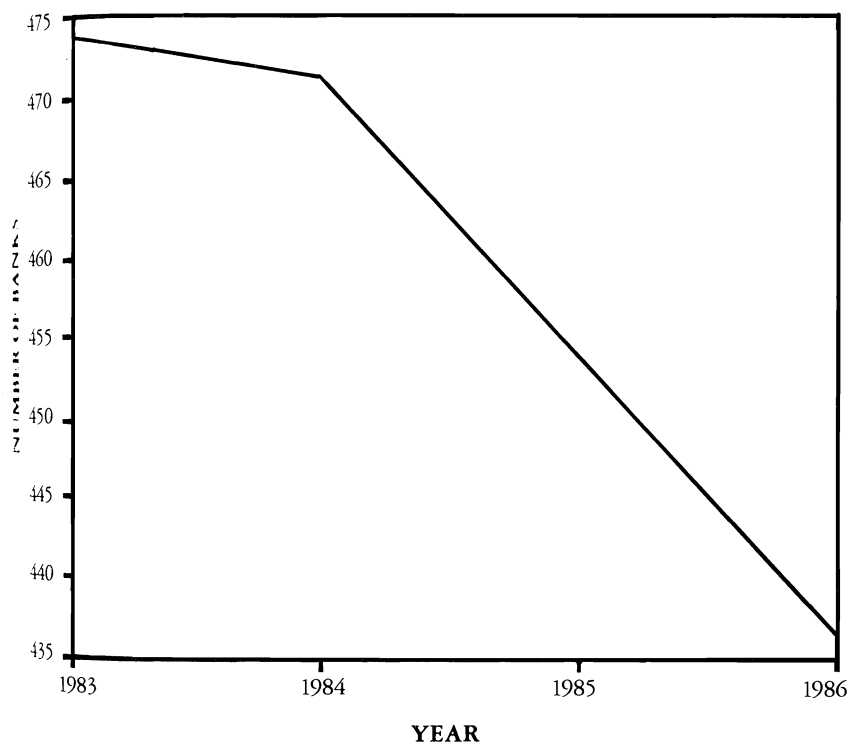
The Banking Industry

This section provides an overview of profitability for the Nebraska banking industry. The data show a clear difference in performance between large banks and community banks.

Number and Size of Banking Institutions

Nebraska's banking industry consists essentially of small institutions. Figure 1 shows the number of banks in Nebraska in 1983, 1984, 1985 (the last year for which

FIGURE 1
Banks in Nebraska



Source: Sheshunoff & Company, Inc. *Banks of Nebraska: National and Statewide Bank Performance Standards*, 1986. Austin: Sheshunoff & Company, Inc., 1986.

complete data are available), and 1986. Respectively, the numbers are 474, 472, 453, and 437. Table 1 shows that 98 percent of these banks had less than \$100 million in assets in 1985, and 89 percent had less than \$50 million.

Table 1 - Number and size of banks, Nebraska, 1985

Assets	Banks	
	Number	Percentage of total
\$1 billion and over	3	0.7
\$500-\$999 million	1	.2
\$100-\$499 million	14	1.0
\$50-\$99 million	40	9.0
\$25-\$49 million	97	21.0
\$10-\$24 million	167	39.0
\$0-\$9 million	131	29.0
Total	453	100.0

Source: Sheshunoff & Company, Inc. *Banks of Nebraska: National and Statewide Bank Performance Standards, 1986*. Austin: Sheshunoff & Company, Inc., 1986.

Table 2 illustrates loan portfolio composition. Agricultural production loans, followed by commercial and industrial loans, comprise the major proportions of

Table 2 - Domestic loans as a percentage of total assets, Nebraska banks, 1985

Type of loan	Percentage of total assets	
	Median	Average
	Percent	
Commercial and industrial	7.0	11.9
Real estate	7.1	9.3
Agricultural production	22.8	15.7
Individual	4.7	9.8

Source: Sheshunoff & Company, Inc. *Banks of Nebraska: National and Statewide Bank Performance Standards, 1986*. Austin: Sheshunoff & Company, Inc., 1986.

the loan portfolios of banks in Nebraska. The performance of banks with less than \$100 million in assets (community banks) is the focus of this study. These banks are the primary lenders to small businesses and consumers.

Profit Performance

The key performance measure for any bank is profitability. Return on asset (ROA) and return on equity (ROE) variables are commonly used measures of profitability. The larger the ROA and ROE, the greater the profitability. These two measures are related as follows:

$$\text{ROE} = \text{ROA} \times \text{EM},$$

where EM is the equity multiplier. The equity multiplier is equal to the ratio of assets to equity and indicates the degree of financial leverage used by the bank.

Tables 3 and 4 indicate the profit performance for the Nebraska banking industry. Performance for 1985 was poor. Table 3 shows an average ROE of 4.91

Table 3 - Return on equity analysis, Nebraska banks, 1981-85

Variable	1981-85		1985	
	Median	Average	Median	Average
	Percent			
Return on equity	11.48	11.27	6.32	4.91
Return on assets	1.07	.91	.62	.41
	Ratio of assets to equity			
Equity multiplier	10.73	12.38	10.19	11.98

Source: Sheshunoff & Company, Inc. *Banks of Nebraska: National and Statewide Bank Performance Standards, 1986*. Austin: Sheshunoff & Company, Inc., 1986.

percent and an average ROA of 0.41 percent, which are below national averages. The degree of financial leverage is indicated by an average EM of 11.98. By contrast, table 3 shows better performance when the average of several recent years is considered. The average ROE for 1981-85 is 11.27 percent and the ROA is 0.91 percent. Financial leverage was also slightly greater, with an EM of 12.38. The large difference in ROE was accounted for mainly by the large difference in ROA, with little difference in EM.

Return on assets data, broken down by size of bank, for 1985 and 1981-85 are shown in table 4. Considerable variation is shown among the various size classes. In most cases, 1985 was a poor year compared with the 1981-85 average. Generally, banks with less than \$100 million in assets had a lower ROA than those with assets greater than \$100 million. In 1985, banks in the \$10-\$24 million size class had especially poor performances.

Table 4 - Return on asset analysis, Nebraska banks, 1981-85

Assets	Average return on assets	
	1981-85	1985
	Percent	
\$1 billion and over	0.71	0.42
\$500-\$999 million	1.01	1.17
\$100-\$499 million	1.15	.74
\$50-\$99 million	.95	.27
\$25-\$49 million	1.15	.50
\$10-\$24 million	.94	.17
\$0-\$9 million	.88	.44

Source: Sheshunoff & Company, Inc. *Banks of Nebraska: National and Statewide Bank Performance Standards, 1986*. Austin: Sheshunoff & Company, Inc., 1986.

Table 5 provides more information about smaller banks for 1985. The contrast between the \$10-\$24 million and \$100-\$499 million classes is striking. A lower ROA for the smaller size class, coupled with a lower degree of financial leverage, led to a substantially lower ROE for the smaller size class banks.

Table 5 - Performance of Nebraska banks, selected asset sizes, 1985

Assets	Average		
	ROA	EM	ROE
	Percent		Percent
\$100-\$499 million	0.75	12.60	9.45
\$50-\$99 million	.21	12.24	2.57
\$25-\$49 million	.48	10.79	5.18
\$10-\$24 million	.17	9.94	1.69

Source: Sheshunoff & Company, Inc. *Banks of Nebraska: National and Statewide Bank Performance Standards, 1986*.
Austin: Sheshunoff & Company, Inc., 1986.

The difference in performance between large and small banks can be traced to many causes, including:

- The difference between interest income and interest expense (net interest margin) has fallen for all banks but more so for small banks.
- The quality of loan portfolios for small banks has deteriorated because of the poor agricultural economy.
- Small banks have not been able to generate noninterest (fee) income to the same extent as large banks.

According to Keeton and Hecht (1986), the net interest margin fell substantially for both small agricultural and nonagricultural banks from 1981 through 1985 in the Federal Reserve Tenth District, which includes Nebraska. The reduction was slightly greater for the small agricultural banks because of substantial increases in problem agricultural loans. On the other hand, net interest margin for large banks declined, and then increased, over the same period. For these banks, net interest margin was actually slightly higher in 1985 than in 1981.

Apart from the problems associated with the agricultural sector, some of the continuing, longer term difficulties faced by community banks are due to deregulation in the financial services industry.

Deregulation and Community Banks

Over the past two decades considerable progress has been made in eliminating restrictions on the types of services provided by depository institutions, in increasing the interest rates paid on deposits, and in locating depository institutions in various geographical areas. All commercial banks have been affected by deregulation. However, the impact on small community banks has been, and will continue to be, different from the impact on larger urban banks.

Community banks face different competition now. They must be concerned about competition from other commercial banks; depository institutions, such as savings and loan associations; and the nonfinancial corporations that are moving into the financial services industry.

Deposit Rate Deregulation

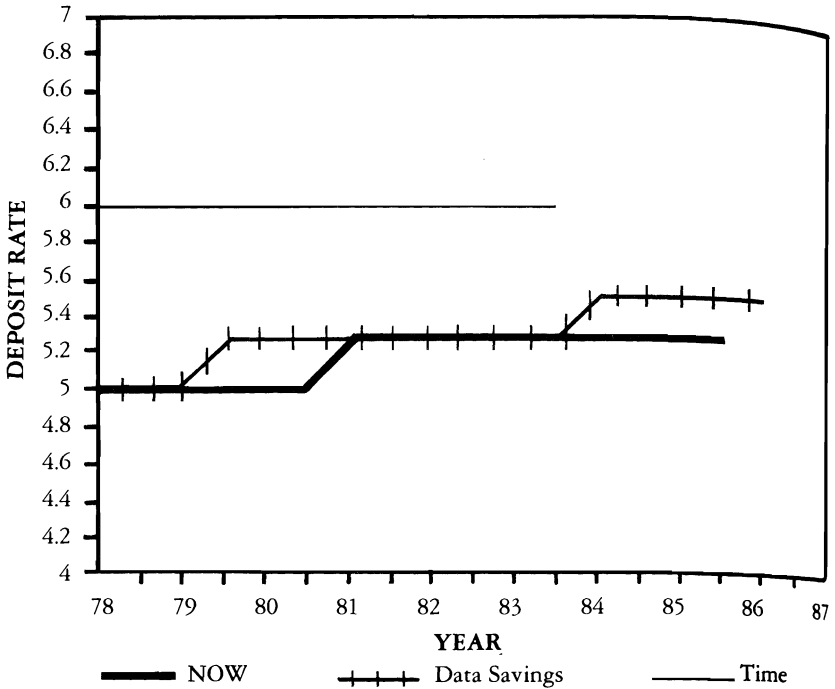
For over 50 years, commercial banks were restricted in the amount of interest they could pay on their customers' deposits. The Banking Act (Glass-Steagall Act) of 1933 forbade the payment of interest on demand deposits (checking accounts) and enabled the Federal Reserve System to impose ceilings on the rates payable on savings and time deposits at commercial banks, because price competition for deposits was considered an unsound banking practice. Savings and loan associations (governed by the Federal Home Loan Bank Board) were placed under similar restriction in 1966 when the Interest Rate Control Act was passed.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) provided for the gradual removal of restrictions. All savings and time deposit rate ceilings were removed by March 31, 1986. As figure 2 indicates, ceilings were eliminated first on time deposits, then on Negotiable Order of Withdrawal (NOW) accounts, and, finally, on savings accounts.

The removal of ceilings affected large and small commercial banks differently. Two characteristics of bank operations and financial structure contribute to this result. First, large banks produce deposits at lower average operating costs than small banks. In other words, there may be economies of scale in the production of deposits. Second, small banks hold a larger proportion of their liabilities in the form of deposits subject to ceilings than large banks. Consider the effect of each characteristic.

The costs to the bank of supplying deposits consist of operating costs and interest costs. Operating costs exhibit economies of scale. That is, average operating costs (operating costs per dollar of deposits) tend to

FIGURE 2
Maximum Deposit Rates¹



¹ Rates are reported for January 1 and July 1 of each year.

Source: Board of Governors of the Federal Reserve System. *Federal Reserve Bulletin*. Washington, DC, various issues.

decrease as total deposits increase. Thus, larger banks can supply deposits at a lower average operating cost than small banks. Large and small banks supply deposits at the same interest rate when interest rates are controlled. Therefore, the average total costs (operating plus interest) will be lower for large banks than for small banks.

Large and small banks use most of their deposit funds to make loans and buy securities in competitive markets. There is little difference between the interest rates received by each on loans and securities of comparable risk. But, because smaller banks have higher

average costs of maintaining deposits, their profit margins are smaller than those of larger banks, unless they accept more risky loans with correspondingly higher interest rates. If small banks are to maintain a satisfactory profit margin without undue risk, it is to their benefit to keep interest costs down through government-imposed deposit rate ceilings.

When deposit rate ceilings are removed, small banks are placed at a disadvantage. If they fail to increase their rates to new, market-determined levels, they lose customers. If they increase their rates, and, thus, their costs, they may convert a small profit margin into a loss.

The issue is complicated because more small bank liabilities are deposits that are subject to deposit rate ceilings. An increase in deposit rates, due to the removal of ceilings, will affect a larger proportion of small bank liabilities than large bank liabilities. This means that total interest costs for small banks will rise relatively more than those for large banks. Even in the absence of differences in operating costs, the removal of deposit rate ceilings will reduce the profits of small banks more than the profits of large banks.

It is too early to assess the full impact of the removal of deposit rate ceilings. At this point, the projected effects contain an element of conjecture. However, some research has addressed this subject. Benston and others (1982 and 1983) indicate that there are significant economies of scale for small banks up to about \$100 million in deposits. Community banks, as defined in this chapter, fall into this category. Beyond \$100 million in deposits, economies appear to be insignificant.

Approaching the problem from another perspective, James (1983) analyzes the effect of adjustments in

deposit rate ceilings prior to 1980. A change in bank profitability due to changes in deposit rate ceilings should have an effect on the market value of the bank's stock. James concludes that certain deposit rate increases or removals affected smaller banks adversely, while benefitting larger banks. Should his conclusions hold for the changes embodied in the DIDMCA, Nebraska's community banks would be placed at a disadvantage.

Since the removal of deposit rate ceilings, small banks have not been tested because interest rates have been low or below the old ceiling rates. For example, rates on NOW accounts are significantly lower now than they were 2 years ago. The test for Nebraska's community banks will come when, and if, market interest rates begin to climb rapidly beyond the old ceiling levels.

Product Deregulation

Twenty years ago commercial banks occupied a unique niche in the financial services industry. Banks were, as they are now, the dominant financial intermediary. Banks were the only institutions that could offer checking accounts to their customers. Banks were more diverse than other institutions in their lending activities. They lent to consumers and businesses; bought corporate and government bonds; made mortgage loans; bought money market securities, such as commercial paper and U.S. Treasury bills; and dealt in a full range of financial assets, except corporate stock.

Deregulation changed all that, not so much by limiting the powers of banks, but by expanding the powers of competing financial institutions. Banks no longer have a monopoly over checkable deposits. Other depository institutions, such as savings and loan associations, are

now able to compete with commercial banks in the market for consumer loans. Competition for interest bearing deposits has intensified, and banks and other depository institutions offer a range of deposits with varying maturities and yields.

The changes are not all negative for commercial banks. A small interest advantage that savings and loan associations had over commercial banks on savings accounts is gone. Further, many banks now compete in new areas, such as discount brokerage and credit cards.

While large banks face a range of new possibilities, the same cannot be said of community banks. For example, credit card debt at commercial banks has grown about 20 percent per year over the last 5 years. It is a lucrative business for commercial banks. However, it is unlikely that community banks will share in this market. The start-up costs are simply too great for community banks.

On the other hand, community banks are unable to avoid the competition they face from other institutions. For example, savings and loan associations offer NOW accounts, which compete with the checking accounts of community banks. Savings and loan associations are also supplying consumer credit, a market that is also important to community banks. This competition is almost unavoidable because federally chartered savings and loan associations can establish branches throughout Nebraska. Thus, in any town, a community bank may be forced to compete with a branch of a large and powerful savings and loan association.

Geographical Deregulation

Despite deposit rate and product deregulation, a well managed community bank can survive if competing

institutions are unable to enter its primary market. However, deregulation has begun to break down geographical barriers.

Large banks present a competitive threat to community banks because they can locate branches in the same market areas. For years, community banks were shielded by restrictive branching laws in Nebraska and by federal laws that restricted interstate branching. For example, the Douglas Amendment to the Bank Holding Act of 1956 prevents a bank holding company located in one state from owning a bank in another state without that state's permission. For this purpose, a bank is a facility that makes commercial loans and accepts demand deposits.

Nebraska law (1983) permits an out-of-state bank holding company to establish a new bank in the state, but the conditions are restrictive (King, 1984). The bank is limited to one office with minimum capital of \$2.5 million. The new bank must employ at least 50 residents of Nebraska within 1 year of its establishment. Further, the bank must not operate in a way that is likely to attract customers from the general public. An outside bank holding company can also acquire a Nebraska bank, but only if the holding company owned at least two in-state banks prior to 1963.

While this may sound like significant protection for community banks in Nebraska, it really is not. An office could be established to grant loans but not receive demand deposits. This office would not be a bank, but it could be a finance company subsidiary of a bank holding company. Deposits could be received through the mail and the main office could be contacted by telephone. Insured certificates of deposit could be sold through a broker, avoiding the establishment of a deposit-taking office.

These are a few of the many ways out-of-state banks, or bank holding companies, can avoid geographical restrictions. Competition faced by Nebraska's community banks, therefore, extends beyond the local community and state boundaries.

New Competition

Competition for financial services is no longer confined to a few industries or geographical areas. Community banks compete in the same market as other banks, savings and loan associations, insurance companies, retailers, security dealers, and others. Regulations that delineated the markets for various institutions have been breached or eliminated. Community banks must now compete with savings and loan associations for checkable, savings, and time deposits. These two institutions now also compete for consumer and business loans.

But, in a broader sense, the competition faced by community banks comes not only from depository institutions, such as savings and loan associations and mutual savings banks, but also from nondepository financial and nonfinancial organizations. Table 6 shows the ways in which several types of organizations have expanded into the financial services industry through subsidiaries and financial institutions other than banks. While commercial banks have expanded their services, the services offered by insurance companies, retailers, and security dealers have expanded dramatically.

The expansion of services has been enhanced by deregulation, but it occurred in the absence of deregulation too. For example, savings and loan associations were able to expand into consumer loans as a result of congressional action in 1980 and 1982. On the

Table 6 - Financial services offered by various institutions in the United States, 1960 and 1984

Service	Banks		Savings and loans		Insurance companies		Retailers		Security dealers	
	1960	1984	1960	1984	1960	1984	1960	1984	1960	1984
Checking	x	x		x		x		x		
Saving	x	x	x	x		x		x		x
Time deposits	x	x	x	x		x		x		
Installment loans	x	x		x		x		x		x
Business loans	x	x	x	x		x		x		x
Mortgage loans	x	x	x	x		x		x		x
Credit cards		x		x			x	x		x
Insurance					x	x		x		x
Stocks, bonds, brokerage underwriting		x		x		x		x	x	x
Mutual funds						x		x	x	x
Real estate				x		x		x		x
Interstate facilities		x		x		x		x		x

Source: Koch, D. L. "The Emerging Financial Services Industry: Challenge and Innovation," Federal Reserve Bank of Atlanta, *Economic Review* (1984):25-30.

other hand, insurance companies expanded by circumventing the restrictions of the Bank Holding Act. A company could obtain a bank charter and offer all banking services except demand deposits or commercial loans. Thus, the institution does not complete the act's definition of a bank. This type of financial institution could offer federally insured deposits and other services without being constrained by the Bank Holding Act.³

Community banks must now consider all corporations and mutual associations to be potential competitors. However, by virtue of its size and market, the typical community bank may be unable to fight back in kind. As mentioned earlier, costs prevent community banks from entering the credit card business and obtaining the associated consumer credit business. In addition, they have lost many automobile loans (the largest element of banks' consumer loans) as a result of cut-rate lending by automobile manufacturers.

Actions can be taken to promote the survival of community banking without attempting to make community

banks all things to all people. The experience of food retailers may provide a model (Kaufman and others, 1984). Large supermarkets and small retail stores coexist by appealing to particular segments of the market and by making use of various technologies. This suggests strategies for commercial banks, because it is not clear that all consumers want to bank at a financial supermarket (Bennett, 1984).

Strategic Responses to Deregulation

In this section, we consider various financial, technological, and market strategies that small community banks might adopt, given the current environment of deregulation.⁴

Financial Strategies

Financial strategies can be delineated into lending, fee income, expense control, capitalization, interest rate risk, and operating risk.

Lending. Small banks in Nebraska supply loans to farmers, small businesses, and individuals. Academics, regulators, and industry practitioners are concerned that the retail loan market will be affected by offices of institutions other than banks and financial services companies. Yet, the demand for such loans offers small community banks new opportunities to pursue profitable outlets for funds. First, because of volatile interest rates, firms have tried to reduce long-term, fixed-interest charges by using additional short-term assets. Banks have responded to this trend by using asset-based lending to finance working capital needs. Second, the demand for housing and consumer durable goods has

increased. These favorable patterns in retail loan markets have implications for small banks.

Traditionally, small banks have been deposit-oriented. Prior to deposit rate deregulation, the major problem was obtaining an adequate share of the deposit base to maintain a reasonable level of loan service. This led banks to seek borrowers who could leave large balances on deposit. As agricultural loans produced lower deposit balances, many small banks shied away from farm credit.

Today, the interest rate environment has changed small banks by making them more loan-oriented. The emphasis is on high-quality credits with good earnings potential to maintain competitive deposit rates and services.

The increased demand for consumer credit presents new opportunities for growth to small banks. This growth could be managed profitably by using technology to reduce production costs. If cost efficiencies are assumed, small banks could obtain an adequate share of the consumer market.

Small banks should be able to excel in personalized services. Typically, this approach works if the bank focuses on a select market segment, establishing a total funds relationship with each customer.

All community banks must develop marketing strategies. There is no reason to suspect that they will not be faced by the marketing principles common to other service industries.

Fee Income. Small banks are in the process of refining their noninterest charges for services. Value-adding strategies state that service-fee income should be geared to the prices of alternative resource inputs. This should be an effective way to boost noninterest revenues.

Also, new services, such as data processing for small businesses, can supplement fee income. Cooperative relationships with other banks may be the best approach for small banks with very little data processing capabilities.

Expense Control. Previous research indicates that expense control is the most critical performance determinant for banks. The shared-cost nature of producing salaries, benefits, and other expenses makes cost budgeting more difficult. Microcomputers offer an inexpensive method of recordkeeping that could detail the daily cost-revenue cycles of banks. Educational institutions could provide support for critical microcomputer technology and develop educational programs for bank personnel.

Capitalization. Small banks have had much higher capitalization than large banks. New regulatory guidelines regarding primary and secondary capital have made standards for small and large banks more uniform. Thus, deregulation should allow small banks two major benefits. First, added leverage can magnify smaller asset earnings to support earnings on equity. Second, small banks will be able to expand their asset bases more quickly; therefore, growth will be enhanced. Such growth may be the most effective way to reach economies of scale.

Interest Rate Risk. Interest rate risk relates to the potential effects of interest rate changes on the liquidity and profitability of a bank. Experts state that analysis of interest rate gap is the best strategy for overcoming interest rate risk. Duration matching, as opposed to maturity matching, is the procedure to use in

implementing this approach. Duration indicates when half of the investment's cash flow in present value will be received. Because the timing of cash flows is considered, it is a better measure of changes in interest rates than the maturity of a financial claim.

Operating Risk. Operating risk relates to the potential inability of a bank to produce financial services at a competitive price. A possible cost inefficiency to which small banks may be susceptible is higher consumer costs. If customer costs are not competitive, small banks could face decreasing demand and, thus, higher operating risk than large competitors.

Technological Strategies

Technological strategies can be classified as payments services, service portfolios, and production and delivery of services.

Payments Services. In today's payments system, checking accounts, credit cards, automated teller machines, and debit cards are the main forms of funds transfer. As electronic technology has become more important, two views of its effect on small and large banks have arisen. First, the shakeout theory states that only larger institutions will be able to accumulate sufficient capital and management expertise to deliver costly technological services. Second, the divisibility theory argues that third-party delivery systems should allow small institutions to reach cost-per-unit output parity. From this perspective, start-up costs could be handled by pooling resources, and technological barriers would not be formidable because most equipment is oriented toward the end user.

An alternative to correspondent banking for automating payments services is the bankers' bank. By definition, these banks are owned by a group of independent community banks in a particular state. Services are provided for a variety of activities. Out-of-state banks may subscribe to certain services. This creates an interstate network of many small banks. The approach overcomes capital and risk barriers that large banks and holding companies can circumvent because of their size. Thus, small banks can cooperatively produce services and deliver them to geographically dispersed regions.

Another method of delivering automated payments services is to utilize a joint venture to share the high fixed costs of production. For instance, a network may be shared by many banks to expand available ATM (automated teller machines) outlets for consumers.

Will the new technology increase unit costs of output for small banks? First, small banks must employ third-party sources to produce technological services in which economies of scale allow them to lower costs. Second, small banks must introduce microcomputers into everyday operations. They can help managers identify cost-control problems, and information systems can be important tools for profit analysis.

Service Portfolios. Portfolio services allow individuals to diversify their financial assets and to lower their transactions costs. Diversification is achieved by purchasing numerous assets with returns over time that are less than perfectly correlated. Also, it seems reasonable that customers using many services from the same institution should bear lower transactions costs. Therefore, the multiple-service functions of financial institutions may be demanded.

Given the legal and regulatory barriers to entry into portfolio services, banks must attempt to change state laws or to use symbiotic banking relationships. For example, many banks have leased space on their premises to financial companies that sell services that are not offered by the bank. Both lessor and lessee benefit from this relationship, and it creates one-stop shopping.

Production and Delivery of Services. Small banks tend to separate the production and delivery of automated, capital-intensive services that can be purchased from low-cost producers. This allows the small community bank to compete technologically with larger competitors. Low-cost producers enable small banks to reprice packages of services and products in unique ways for the needs of their clientele. The personal nature of delivery in many financial services enables small banks to develop strong relationships with customers, and they may have an advantage over larger institutions if they can deliver an assortment of services to satisfy their customers.

Market Strategies

Market strategies can be subdivided into regulatory issues, survey data on bank services and prices, and bank performance goals.

Regulatory Issues. New services are made available to the public upon the approval of a bank holding company's application. Horvitz and Shull (1964) reported that when unit banks merged into national banks, generally, five new services were offered. Kolari, Rose, and Riener (1983) showed that independent banks

acquired by bank holding companies increased their service offerings. Unfortunately, it was also found that many planned changes or additions to services were not implemented; when they were, the public did not use them. Therefore, the basic products most demanded by the public were being served by banks before they were acquired by bank holding companies. Thus, the most important variable may not be changes in products but in prices.

Survey Data on Bank Services and Prices. Since the early 1960s, the structure of banking in the United States has been changed by the growth of branch banks and bank holding companies. Their benefit is that they provide a multi-office marketing network for selling bank services throughout a geographic area. A survey study by Rose, Kolari, and Riener (1985) determined that smaller institutions emphasized transaction services, including automatic loan repayment, deposit by mail, self-service envelopes, automatic deposit transfers, and depository and payroll services for businesses. Branch banks supplied a variety of services to the public, and independent unit banks offered the fewest services.

The evidence suggests that banks with deposits in the range of \$25-\$100 million emphasize consumer business more than the very small and very large banks. Also, banks with deposits in excess of \$100 million recorded more competitive deposit rates. Finally, loans associated with small and large banks seem to be priced uncompetitively. For example, small banks averaged the highest rates on farm loans. One explanation is that banks concentrating in individual lending acquire riskier loans with higher average returns than other banks.

Bank Performance Goals. Rose, Kolari, and Riener (1985) state that the goals of profitability, growth, and market share were more important as bank size increased. Banks in the \$10-\$25 million deposit range view profitability and growth to be important; however, larger banks emphasize competitive performance goals.

Banks should rank their goals. For some, profitability will be of utmost importance, followed by growth. For others, profitability or growth alone will be important. Without question, banks will need to plan more than they have in the past to meet a given level of performance.

Policy Recommendations and Conclusions

Nebraska's community banks are facing difficult times. The agricultural crisis and deregulation of the financial services industry have combined to lower the performance levels of community banks. Deregulation may have more long-term consequences than a weak agricultural economy. In 2000, the financial services industry may bear little resemblance to the current one.

Throughout U. S. history, resistance to change was usually the hidden motivation for supporting the regulation of industry. Yet, a dynamic economy coupled with technological advances will produce innovators who are able to breach the regulatory barriers. Nowhere has this been more evident than in the financial services industry in recent years.

In the face of change, some institutions attempt to survive by demanding new regulations. However, other institutions view change and deregulation as a process that creates opportunities. Institutions led by innovators will seek new markets and new technologies to enhance their dual function of serving the customer and earning a

profit. These are the institutions that will define the nature of the financial services industry in the future.

Nebraska has always had its share of innovators. The state capitol building, the Unicameral Legislature, Arbor Day, the planted national forests, and the Interstate 80 sculptures are a few examples of the state's innovative spirit. We expect that this spirit will be drawn upon by Nebraska's community banks.

We argue in this chapter that deregulation and the avoidance of regulation have stressed Nebraska's community banks; but, we also argue that ample opportunities are provided by this new environment. The relatively small size of community banks need not be a barrier that retards the development of viable organizations. On the contrary, smallness can promote the flexibility that is necessary to adapt to change.

The suggestions presented previously are designed to be implemented by individual banks or groups of banks. But, action can be taken at the state level through changes in public policy. Current state laws and regulations should be reviewed to determine the extent to which they encourage or discourage the development of banks and other financial corporations. Also, a strong business climate will help community banks. Thus, policies that improve Nebraska's business climate are as important as those that affect the financial sector.

For example, does Initiative 300 interfere with the ability of Nebraska's community banks to supply financial services? Will it inhibit the growth and development of community banks in the future? Does it discourage nonfinancial corporations that might otherwise provide increased business for community banks in Nebraska?

Nebraska is one of a handful of states that severely restrict the establishment of new banks by out-of-state

bank holding companies. Is the protection afforded by this, to in-state banks, worth the negative effects of its antibusiness message? Is the protection significant at all?

Are community banks really helped by Nebraska's antibranching law? Would the law's elimination encourage economic development and growth in markets for all financial institutions, including community banks?

Nebraska's tax system has been changed recently. Have all the appropriate changes been made? As business expands, in what ways can the tax burden for firms be further reduced? Innovation is going to be one of the keys to success for community banks. Does the tax system encourage innovation?

Resource constraints prevent community banks from having access to information that many large banks acquire. State government, and its agencies, have public information that could be useful to community banks. Could this information be made available to community banks for modest fees? The low cost of microcomputers now makes it feasible to disseminate timely information to remote locations throughout the state.

Change in the financial services industry is inevitable. State banking policy should assist Nebraska's banks by removing barriers to change, by improving the availability of useful information and expertise, and by encouraging innovation. It is time for Nebraska to become a leader in enlightened public policy toward the financial services industry.

Endnotes

1. According to Hagerman and Gajewski, "Patterns of Financial Institution Failures," about 55 percent of the FDIC-insured banks in the United States that failed from 1983 through 1986 had below-average concentrations of farm loans. This group included banks in states with faltering energy industries.

2. The data in this section are from Lyons, Zomback and Ostrowski, *Depository Institutions Performance Directory*.
3. On August 10, 1987, President Reagan signed the Competitive Equality Banking Act. This legislation stops the further creation of this type of financial institution and restricts the growth of the more than 165 existing institutions. Whether this represents a delay in ongoing deregulation, or a reversal of the deregulation movement, remains to be seen.
4. This section draws heavily on Fraser and Kolari, *The Future of Small Banks*.

References

- Bennett, V. "Consumer Demand for Product Deregulation." Federal Reserve Bank of Atlanta, *Economic Review* (1984):28-40.
- Benston, G. J., G. A. Hanweck, and D. B. Humphrey. "Scale Economies in Banking: A Restructuring and Reassessment." *Journal of Money, Credit, and Banking* 1(1982):435-56.
- Benston, G. J., A. N. Berger, G. A. Hanweck, and D. B. Humphrey. "Economies of Scale and Scope in Banking." *Proceedings of a Conference on Bank Structure and Competition*. Chicago: Federal Reserve Bank of Chicago, 1983, p. 432-55.
- Fraser, D. R., and J. W. Kolari. *The Future of Small Banks in a Deregulated Environment*. Cambridge: Ballinger Publishing Company, 1985.
- Hagerman, D., and G. Gajewski. "Patterns of Financial Institution Failures: Some Thoughts on Policy Implications." *Banking and Economic Review* (1987):5-10.
- Horvitz, P. M., and B. Shull. "The Impact of Branch Banking on Bank Performance." *National Banking Review* (1964):143-88.
- James, C. "An Analysis of Intra-industry Differences in the Effect of Regulation." *Journal of Monetary Economics* 12(1983):417-32.
- Kaufman, G. G., L. R. Mote, and H. Rosenblum. "Consequences of Deregulation for Commercial Banking." *Journal of Finance* (1984):789-802.

Keeton, W. R., and K. M. Hecht. "Banking Performance in Tenth District States." Federal Reserve Bank of Kansas City, *Economic Review* (1986):3-22.

King, B. F. "Interstate Banking: Issues and Evidence." Federal Reserve Bank of Atlanta, *Economic Review* (1984):36-45.

Koch, D. L. "The Emerging Financial Services Industry: Challenge and Innovation." Federal Reserve Bank of Atlanta, *Economic Review* (1984):25-30.

Kolari, J. W., P. S. Rose, and K. W. Riener. "Convenience and Needs: A Survey of Holding Company Bank Services." *Issues in Bank Regulation* (1983):26-31.

Lyons, Zomback and Ostrowski, Inc. *Depository Institutions Performance Directory*. Boston: Warren, Gorham and Lamont, Inc., 1986.

Rose, P. S., J. W. Kolari, and K. W. Riener. "A National Survey of Bank Services and Prices Arrayed by Size and Structure." *Journal of Bank Research* (1985).

Sheshunoff & Company, Inc. *Banks of Nebraska: National and Statewide Bank Performance Standards, 1986*. Austin: Sheshunoff & Company, Inc 1986.